BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

SUPREME COURT OF THE UNITED STATES.

KATHERINE KRAFT,
Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

I.

OPINION OF THE COURT BELOW.

The opinion in the Circuit Court of Appeals for the Third Circuit (R., pp. 88-91) was reported in 111 Fed. (2d) page 370 (C. C. A., 3rd Circuit, April 16, 1940). The opinion in the Board of Tax Appeals (R., p. 77) was reported in 40 B. T. A. , No. 44; C. C. H. Dec. 10774, July 18, 1939.

II.

JURISDICTION.

1. The date of the judgment to be reviewed is April 16, 1940.

2. The statutory provision which is believed to sustain the jurisdiction of this Court is Judicial Code, Section 240.

3. The facts, showing the nature of the case in rulings below are such as to bring it within the jurisdictional provision relied upon, are as follows:

Petitioner here was a party to this cause in the Circuit Court of Appeals for the Third Circuit (R., p. 91) which

Court has rendered a judgment affirming the decision of the Board of Tax Appeals (R., p. 91, fol. 93).

4. The cases believed to sustain said jurisdiction are as follows:

Helvering vs. Clifford, U. S. ; 60 S. Ct. 554, 84 L. ed. 504 (February 26, 1940);
Helvering vs. Wood, U. S. ; 60 S. Ct. 551, 84 L. ed. 511 (February 26, 1940).

III.

STATEMENT OF THE CASE.

This has already been stated in the preceding Petition under I, pages 1-5, which is hereby adopted and made a part of this brief.

IV.

SPECIFICATION OF ERRORS.

1. The Court erred in holding that Section 166 of the Revenue Act of 1934 should be so construed as to tax to Petitioner the income for the year 1934 from the trusts here involved.

2. The Court erred in holding that the taxing to Petitioner of the 1934 income of the five trusts here involved under Section 166 of the Revenue Act of 1934 did not (a) deprive Petitioner of her property without due process of law, (b) did not take Petitioner's property for public use without just compensation and (c) did not lay a direct tax upon Petitioner without being in proportion to the census or enumeration.

V.

ARGUMENT.

Point A.

The retroactive effect of a new tax statute taxing the Petitioner for the income of the Beneficiaries of the trusts here involved is an important question of federal law which has not been settled by this Court.

Point B.

The decision of the Circuit Court of Appeals for the Third Circuit in this case is the decision of a federal question in a way probably in conflict with applicable decisions of this Court.

POINT A.

THE RETROACTIVE EFFECT OF NEW TAX STATUTES TAXING THE PETITIONER FOR THE INCOME OF THE BENEFICIARIES OF THE TRUSTS HERE INVOLVED IS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN SETTLED BY THIS COURT.

Section 1 of the Revenue Act of 1934 (App., p. 22) under which the deficiency is assessed specifically provides that the provisions of Title 1 of the Act shall apply only to the taxable years beginning after December 31, 1933. Said Act did not become a law, however, until May 10, 1934, so that it is retroactive for the period from May 10, 1934 to January 1, 1934.

Prior to the passage of the 1934 Revenue Act, and at all times since the trusts involved herein were created until May 10, 1934, similar provisions in the Revenue Acts in force during that period provided that the income of a trust was taxable to the grantor, where the grantor had the power to re-

vest in himself title to the corpus "at any time during the taxable year". Conversely, the income of such trusts was not taxable to the grantor where he did not have such a power "at any time during the taxable year" (Section 166, Revenue Act of 1928 (App., p. 22); Section 166, Revenue Act of 1932 (App., p. 22)).

The Revenue Act of 1934, Section 166, effective May 10, 1934, provides:

> "Where at any time power to revest in the grantor title to any part of the corpus of the trust is vested—(1) in the grantor * * * alone * * * then the income of such part of the trust shall be included in computing the net income of the grantor."

Section 166 of the 1934 Act differs only from the similar section in the 1932 Act, which later Act was in force at the time the one trust involved herein was amended and at the time when the other trusts were created, in that in the 1934 Act there was left out the words underlined in the following phrase from the 1932 Act:

> "Where at any time *during the taxable year* the power," etc.

Under the terms of the trusts involved here the notice of revocation of the trust for any succeeding year must be served on or before December 26 in any preceding year (R., p. 73). Therefore, to revoke any of the instant trusts for the year 1934, the notice must have been served on or before December 26, 1933. On this latter date all of the trusts had been in effect for over a year under a Revenue Act which did not tax the income of such trusts to Petitioner. On this latter date the Revenue Act of 1934 not only was not a law, its proposed provisions were not even within public knowledge. On December 26, 1933, therefore, no knowledge can be imputed to Petitioner that, under a new Revenue Act to

be passed six months later, the income from the trusts might be taxable to the Petitioner even though at the time such law would be effective she would have no power to procure for herself, by revocation of the trust, title to the corpus and the income from said trusts upon which she was going to be taxed. After December 26, 1933 Petitioner had no power, by revoking the trusts, or otherwise, to procure for herself in 1934 any part of the corpus or the income of the trust. The income from the trusts was beyond question the property of and payable solely to the beneficiaries of said trusts (Stipulation, par. 9; R., p. 74).

Petitioner admits that if she did not take the necessary steps to revoke the trusts for the year 1935, *et seq.*, the income from said trusts for 1935 would belong to the beneficiaries, but the Petitioner nevertheless would be taxable on the amount of said income for the year 1935 and subsequent years, under Section 166 of the Revenue Act of 1934, because she would have had the opportunity to procure for herself the income for 1935 and subsequent years but had elected not to do so. As to the 1934 income, upon which she is now being taxed, *the 1934 Act did not give her such opportunity.*

Petitioner, under the circumstances here, cannot be taxed for the income of others. To hold otherwise would render the section unconstitutional. (*Hoeper vs. Tax Commissioner of Wisconsin*, 284 U. S. 206.) Section 166 of the Revenue Act of 1934 should be held not to apply to the income of these trusts for the year 1934, but to apply to subsequent years, for it is a familiar rule of law that a statute, which would be unconstitutional as applied to a certain class of cases, and is constitutional as applied to another class, should be held to have been intended to apply only to the latter class. *United States ex rel. Attorney General vs. Delaware & Hudson Company*, 213 U. S. 366; *United States vs. Jin Fuey Moy*, 241 U. S. 394; *United States vs. Goelet*, 232 U. S. 293.

In *Lewellyn vs. Frick*, 268 U. S. 238, the Court said at page 251:

> "* * * Not only are such doubts avoided by construing the statute as referring only to transactions taking place after it was passed, *but the general principle 'that laws are not to be considered as applying to cases which arose before their passage' is preserved, when to disregard it would be to impose an unexpected liability that, if known, might have induced those concerned to avoid it,* and to use their money in other ways. *Schwab vs. Doyle*, 258 U. S. 529, 534, 66 L. Ed. 747, 752, 26 A. L. R. 1454, 42 Sup. Ct. Rep. 391." (Italics ours.)

Although it is true that this Court has on occasion held that a tax statute may be made retroactive so as to tax income for a period prior to the passage of the statute, yet it has never had before it a case where the retroactive provisions of the statute resulted in a tax to A based upon the income of B.

One of the latest cases in this Court on the extent to which a taxing statute may be retroactive is *Welch vs. Henry*, 305 U. S. 134, 83 L. ed. 87. There the Court had before it the constitutionality of a Wisconsin statute passed in 1935 taxing corporation dividends received in 1933. The Court, in approaching the problem, said at page 104 (L. ed.):

> "In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. *Nichols vs. Coolidge*, 274 U. S. 531, 542, 71 L. ed. 1184, 1192, 47 S. Ct. 710, 52 A. L. R. 1081; *Untermeyer*

vs. Anderson, 276 U. S. 440, 445, 72 L. ed. 645, 647, 48 S. Ct. 353; (Citing *Blodgett vs. Holden*, 275 U. S. 142, 147, 72 L. ed. 206, 210, 48 S. Ct. 105); *Coolidge vs. Long*, 282 U. S. 582, 75 L. ed. 562, 51 S. Ct. 306. Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. But there are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive because their incidence is not on the voluntary act of the taxpayer. And even a retroactive gift tax has been held valid where the donor was forewarned by the statute books of the possibility of such a levy, *Milliken vs. United States*, 283 U. S. 15, 75 L. ed. 809, 51 S. Ct. 324, *supra*. *In each case, it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.*" (Italics ours.)

Although the majority opinion held the statute constitutional on the ground that, as Wisconsin could have taxed the dividends in 1933, it could well do so in 1935 and the Court could not assume that the stockholders would have refused to accept the dividends in 1933, if they thought they were to be taxed in 1935, there was a vigorous dissent by Mr. Justice Roberts, in which Justices McReynolds and Butler concurred, in which it was pointed out that what was said in *Milliken vs. United States*, 283 U. S. 15, 25, was peculiarly apposite to the facts in the *Welch* case. Justice Roberts said at page 109, referring to the *Milliken* case:

> "There (referring to earlier decisions) condemning, under the due process clause, retroactive taxes, it was

> stated: 'In both the point was stressed, as the basis of decision, that the nature and amount of the tax burden imposed could not have been understood and foreseen by the taxpayer at the time of the particular voluntary act which was made the occasion of the tax.' Here the nature and amount of this special and peculiar tax could not have been understood and foreseen when the petitioner paid his 1933 income tax."

From the language of both the majority and minority opinions in *Welch vs. Henry, supra,* it becomes apparent that where the tax imposed could not have been understood or foreseen by the taxpayer at the time of the act which brought about the tax, the Court will not hesitate to declare a retroactive taxing statute unconstitutional, particularly when the income taxed never was nor could be the income of the person taxed, nor used for his benefit. (*Hoeper vs. Tax Commissioner of Wisconsin,* 284 U. S. 206, 76 L. ed. 248.)

In the latter case, an income tax statute of Wisconsin taxed the husband for the joint and separate income of both husband and wife. The Court held that such law was unconstitutional, saying at page 251 (L. ed.):

> "Since, then, in law and in fact, the wife's income is in the fullest degree her separate property and in no sense that of her husband, the question presented is whether the state has power by an income tax law to measure his tax, not by his own income but, in part, by that of another. To the problem thus stated, what was said in *Knowlton vs. Moore,* 178 U. S. 41, 77, 44 L. ed. 969, 984, 20 S. Ct. 747, is apposite:
>
> > 'It may be doubted by some, aside from express constitutional restrictions, whether the taxation by Congress of the property of one person, accompanied with an arbitrary provision that the rate of tax shall be fixed with reference to the sum of the property of another, thus bringing about the pro-

found inequality which we have noticed, would not transcend the limitations arising from those fundamental conceptions of free government which underlie all constitutional systems.'"

In the case at bar, the income which has been arbitrarily taxed to Petitioner by the Respondent was in no sense income to the Petitioner under the instant trusts. Once a calendar year had started there was no power in the grantor of the trusts (Petitioner) to recall either principal or income from the trusts for that year. Petitioner's title to both principal and income was gone for the whole of such calendar year. The trustees held the legal title to the trust property and could not return such title to the grantor during the whole of such calendar year. The income from the trusts belonged to the beneficiaries for the whole of such calendar year. The beneficiaries had the right to go into the New York Supreme Court and compel the continuance of those trusts both as to principal and income for the whole of said calendar year, i.e., 1934 (Paragraph 9 of Stipulation; Record, p. 74). The instant trusts imposed no restraint on the beneficiaries' use of the income from said trusts. The beneficiaries could give away or squander the income and the Petitioner could do nothing to impose her will upon the use of this income. Therefore, to now tax the Petitioner for the income from trusts for the year 1934 under the provisions of Section 166 of the Revenue Act of 1934, enacted May 10, 1934, is to do a wholly arbitrary, whimsical and capricious thing.

In order to tax Petitioner on the income from said trusts there must be attributed to Petitioner the ownership of the principal or income from said trusts, whereas she had the ownership of neither for the whole of the year 1934. The grantor had nothing in 1934 which was equivalent to ownership nor was there anything approaching an equivalent to ownership. Here was divestment of title in a permanent and definitive way—permanent and definitive for the whole of 1934. The Petitioner had stripped herself for the whole of

1934 of every interest in the subject matter of the trusts. *The Petitioner had no opportunity to revoke, alter or amend these trusts for the year 1934 after the passage of said Section 166 on May 10, 1934, as she was bound to allow these trusts to continue through the whole of the year 1934.*

We have, therefore, an entirely different situation than was present in the cases now to be discussed.

In *Corliss vs. Bowers,* 281 U. S. 376, the Court held that the income from a trust revocable at any time created prior to 1924 was taxable to the grantor under the 1924 Revenue Act because the trust there amounted to nothing more than an assignment of income which belonged to the grantor and the trust was revocable at any time. The Respondent cannot seriously contend that the trusts involved here involved merely an assignment of income, and certainly the trusts were not revocable at any time during 1934.

Reinecke vs. Smith, 289 U. S. 172, 77 L. ed. 1109, was quite similar to the *Corliss* case, except that there was involved in the *Reinecke* case the necessity of the trustee joining with the settlor in revoking the trust. The Court held, however, that the trustee had no duty to resist revocation, and the case was the same as if the reserved right of revocation had been vested jointly in the grantor and a stranger to the trust.

The opinion of the Circuit Court of Appeals attempts to answer the constitutional question raised here by saying that the case of *Reinecke vs. Smith, supra,* disposes of this contention. In said opinion, it is stated (R., p. 90, fol. 92):

> "In the *Reinecke* case the taxpayer at all times retained the power to repossess the corpora. In the instant case the taxpayer at any time possessed the power to repossess the corpora. In the *Reinecke* case, as in the case at bar, the income sought to be taxed to the grantor had already been received by the cestuis and was not recoverable by the grantor. The measure of control retained by the grantor over the corpora of the trusts is within the literal language of Section 166

and we hold the application of the Section by the Commissioner to have been constitutional."

Certainly under the facts of this case the Circuit Court was in error in stating that the taxpayer at any time "possessed the power to repossess the corpora." It might have stated that "in the instant case the taxpayer at any time in 1934 possessed the power to repossess the corpora after 1934" which is the fact, but certainly the taxpayer did not possess the power to repossess the corpora for 1934 after December 26, 1933 had passed without a revocation of the trust. This is the essential difference between the instant case and the *Reinecke* case, in which latter case the taxpayer had the right at any time to repossess the corpora. It is respectfully submitted that the *Reinecke* case does not dispose of the constitutional question raised here.

In *Burnet vs. Wells*, 289 U. S. 669, 77 L. ed. 1439, the trusts were irrevocable but the income was to be used to pay insurance premiums on policies of insurance on the life of the grantor. The trust was set up in 1922, and under the 1924 Revenue Act it was provided that "Where any part of the income of the trust is or may be applied to the payment of premiums on policies on the life of the grantor * * * such part of the income of the trust shall be included in computing the net income of the grantor." The Court held that the grantor of the trust had, by the provisions of the trust, devoted the income therefrom to the preservation of his own contracts, and therefore the statute, although retroactive, was not so arbitrary and capricious as to be unconstitutional.

Certainly, in the instant case, Petitioner did not nor could not derive any benefit from the income of the trusts for the year 1934. The income was the income of the beneficiaries and not the Petitioner. To tax this income to Petitioner is to do what the Court in *Heiner vs. Donnan*, 285 U. S. 312, 76 L. ed. 772, condemned at page 779, saying:

"* * * Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property

> of B, a result which both the *Schlesinger* and *Hoeper* cases condemn as arbitrary and a denial of due process of law. Such an exaction is not taxation but spoliation."

United States vs. Hudson, 299 U. S. 498, 81 L. ed. 370, involved the Silver Purchase Act of 1934 which put a special tax on the profit realized on the sale of silver bullion. It became a law on June 15, 1934 and the period of retroactivity prescribed for the taxing provisions reached back only to May 15, 1934. The Court pointed out that in that case there had been a forewarning regarding the nature of the tax to be imposed, therefore the retroactivity of the statute was not arbitrary or capricious. Furthermore, the profits from the silver were the profits *of the person taxed* as was the case in *Welch vs. Henry, supra.* As heretofore pointed out, that element is entirely lacking in the present case.

In *Shwab vs. Doyle,* 258 U. S. 529, 66 L. ed. 747, plaintiff's testatrix, a year before the passage of the 1916 Estate Tax Law, gave a million dollars to trustees in trust for others. She died six days after the passage of the act and her estate was taxed for the value of the gift. It was urged that the statute could have no retroactive effect upon the gift made. The Court said at page 534:

> "* * * The initial admonition is that laws are not to be considered as applying to cases which arose before their passage unless that intention be clearly declared. * * * But granting the contention of the defendant has plausibility, it is to be remembered that we are dealing with a tax measure, and whatever doubts exist must be resolved against it."

The Court held that the statute should not be

> "* * * construed to apply to transactions completed when the act became a law. And this, we repeat, is

> in accord with principle and authority. It is the proclamation of both that a statute should not be given a retrospective operation unless its words make that imperative, and this cannot be said of the words of the Act of September 8, 1916 * * *."

The judgment sustaining the tax was reversed.

In *Ochoa vs. Hernandez Y Morales,* 230 U. S. 139, 57 L. ed. 1427, the Court said at page 1437:

> "* * * Whatever else may be uncertain about the definition of the term 'due process of law,' all authorities agree that it inhibits the taking of one man's property and giving it to another contrary to settled usages and modes of procedure and without notice or an opportunity for hearing."

The cases cited in *Welch vs. Henry, supra,* in support of the statement that the contention that the retroactive application of the Revenue Acts is a denial of due process guaranteed by the Fifth Amendment has been uniformly rejected, were all cases where the statute taxed the income or the use of assets of the person taxed. In none of them was involved the taxation of A for the income of B.

In an article in a recent issue of the Harvard Law Review, Vol. 53, p. 1322, "Income Tax on Short Term and Revocable Trusts", the author states at p. 1331, under a note citing the instant case:

> "The constitutionality of the Section as amended apparently has not been questioned although in a situation wherein revocation requires several years advance notice, the grantor might well assert that he is being taxed on the income of another, contending such taxation to be violative of the due process clause (*C. F. Hoeper vs. Tax Commissioner of Wisconsin,* 284 U. S. 206)."

The constitutionality of Section 166 of the 1932 Revenue Act has been questioned and questioned consistently in this case before the Commissioner, the Board of Tax Appeals and the Circuit Court of Appeals. Why the author should state that in a case which required several years advance notice the grantor might raise the constitutional question is not clear. In this case the Petitioner had to give notice prior to 1934 and there would seem to be no difference in principle whether the notice had to be given in December of 1933 or December of 1932 or December of 1931.

To avoid unconstitutionality this Court should read said Section 166 as not applicable to the instant trusts *for the year 1934*, because of the doctrine laid down in *United States ex rel. Atty. Gen. vs. Delaware & H. Co.*, 213 U. S. 366, 407, 408. This case has been many times cited by the United States Supreme Court and stands for the proposition that as between two possible interpretations of a statute, by one of which it would be unconstitutional and by the other valid, it is the plain duty of the Court to adopt that interpretation which will save the act.

Words of a statute have been greatly strained in order to avoid such a construction as would make the statute unconstitutional.

United States vs. Jin Fuey Moy, 241 U. S. 394.

See also *Lucas vs. Alexander*, 279 U. S. 573, 73 L. ed. 851, where the Court said at page 854:

> "* * * In answering it, provisions of the taxing statute enacted as aids in arriving at the answer must be construed with an eye to possible constitutional limitations so as to avoid doubts as to its validity."

POINT B.

THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT IN THIS CASE IS THE DECISION OF A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

For the reasons stated under Point A above, it is respectfully submitted that the decision of the Circuit Court of Appeals in this case is the decision of a Federal question in such a way as to be in conflict with the decision of this Court in *Hoeper vs. Tax Commissioner of Wisconsin*, 284 U. S. 206, which held that one person could not be taxed on the income of another and in *Eisner vs. Macomber*, 252 U. S. 189, which held that the 16th Amendment to the Constitution did not permit direct taxation of property without apportionment.

The income taxed here was the income of the beneficiaries of the trust. The tax of Petitioner is a tax on her principal, not her income and therefore in order to sustain a tax against Petitioner resort must be had to apportionment as set forth in *Eisner vs. Macomber, supra.*

CONCLUSION.

It is respectfully submitted, therefore, that this case is one calling for the exercise by this Court of its supervisory powers by granting a writ of certiorari and thereafter reviewing and reversing said decision.

FRANK M. AVERY,
Counsel for Petitioner.